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380728—56——1

In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 733

WESTERN MARYLAND RAILWAY COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 3–44[1]) is reported at 131 F. Supp. 873. The opinion of the Court of Appeals (Pet. App. 17–19) is reported at 227 F. 2d 576.

JURISDICTION

The judgment of the Court of Appeals was entered December 6, 1955. (Pet. 17.) The peti-

[1] Record references used herein are to the appendix to the taxpayer's brief in the Court of Appeals. Supplemental record references are to Appendix B to the Government's brief in the same court.

tion for a writ of certiorari was filed on March 5, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254 (1).

QUESTION PRESENTED

Whether the finding of the District Court, affirmed by the Court of Appeals, as to the amount of petitioner's equity invested capital allowable under Section 718 of the Internal Revenue Code of 1939 for excess profits tax purposes is supported by the evidence.

STATUTES AND REGULATIONS INVOLVED

The statutory provisions involved are Sections 113 (a) and 718 (a) of the Internal Revenue Code of 1939, and the Treasury Regulations involved are Treasury Regulations 112, Section 35.718–1, which are set forth in the Appendix, *infra,* pp. 19–20.

STATEMENT

Petitioner is the successor[2] of a railroad corporation which in 1910 acquired the property of the Western Maryland Rail Road Company (hereafter sometimes call the "Old Company") as the result of a foreclosure sale. As of March 5, 1908, the Old Company had outstanding $48,718,000 First Mortgage and Divisional Bonds; $2,233,950 Underlying or Leased Line Bonds and

[2] Since petitioner is entitled to include the invested capital of its predecessor (R. 47), for convenience both corporations are sometimes referred to as the "taxpayer" or the "New Company."

Guaranteed Stocks; $10,000,000 General Lien and Convertible 4% Mortgage Bonds (herein referred to as General Lien Bonds), secured by the same properties as the First Mortgage Bonds but subject thereto; and $15,685,400 par value common stock (par $50) (R. 4, 66–67). On that date the trustees under the mortgage securing the General Lien Bonds brought suit to foreclose the mortgage and to appoint a receiver, because of the inability of the Old Company to meet bond interest to become due. The complaint also alleged that the company was insolvent. (R. 4; Supp. R. 15–17.) On the same day the court appointed a receiver for the properties covered by the General Lien Mortgage (R. 4, 48). The anticipated defaults later occurred (Supp. R. 17–22).

Pending the foreclosure a Committee of General Lien Mortgage Bondholders was formed to protect the interests of depositing bondholders (R. 5, 49–60). On July 26, 1909, the Committee submitted to the bondholders a Reorganization Plan (R. 64). After noting in the Plan that the foreclosure proceedings were "well advanced toward final decrees" (R. 65), it stated (R. 6, 67–68):

> It is proposed to effect the reorganization of the [Old] Company by the organization of a new company which shall take over the property of the old company subject to its First Mortgage and its underlying and divisional bonds as specified in the foregoing [financial] statement.
>
> The new company will issue in acquisition of the property of the old company:
>
> $10,000,000 Four Per Cent. Non-Cumulative Preferred Stock

(par value $100), preferred * * *, convertible * * *, redeemable * * *, and

$23,939,500 Common Stock (par value $100) of an authorized issue of $50,000,000.

The holders of certificates of deposit for General Lien and Convertible 4% Bonds will receive:

(a) For principal, 100%, viz: $10,000,000, in new 4% preferred stock,

(b) For unpaid overdue coupons * * * $836,000 [par value], in new common stock.

The required $8,274,160 cash will be raised by sale of $20,685,400 of common stock to a Banker's Syndicate under the management of Blair & Co. who will offer the same as follows:

(a) To the holders of certificates of deposit for $10,000,000 Western Maryland General Lien and Convertible Bonds 50% of their holdings, *i. e.*: $5,000,000 new stock, for 40% of its par value, or	$2,000,000
(b) To the holders of $15,685,400 Western Maryland stock, in exchange for their old stock and on payment of 40% of the par value thereof in cash, 100% of their holdings, *i. e.*: $15,685,400 new common stock for	$6,274,160
	$8,274,160

In addition, the Plan contemplated that the New Company would issue $2,438,160 par value of the new common stock "for expenses of reorganization, compensations, underwriting and other commissions and for reserve" (R. 7, 70).

The Plan also contemplated that the $8,274,160 raised by the sale of the new common stock at $40 per share (as set forth above) would to the extent of $6,762,297 be used to pay obligations incurred by the Receiver between March 1908 and July 1909, for interest on the First Mortgage Bonds, and for equipment and car trust certificates and other secured obligations, while the balance of $1,511,863 would be used for "Improvements and for Current and Miscellaneous

Requirements in Reorganization" (R. 7, 66–67). The Plan made no provision for payment of $1,714,091 of creditors' claims, which it characterized as "Disputed or Forecloseable Claims" (R. 7, 67). Neither the Bondholders' Committee nor anyone representing the Old Company filed the Committee's Plan with the court prior to the foreclosure decree or as an incident to the foreclosure proceedings (R. 95–111; Supp. R. 23–30), and the foreclosure decree made no reference to it.

The Committee entered into an agreement with Blair & Company, as managers for a Bankers' Stock Purchase Syndicate, providing for the sale to the Syndicate, if and when issued, for $8,274,160 in cash, of $20,685,400 par value common stock of the proposed New Company, i. e., at $40 per share, "to be issued as and for the purposes contemplated in the Plan." The Syndicate agreed to offer the stock to the General Lien bondholders and to the stockholders of the Old Company, as provided in the Plan. (R. 7, 74–81.) The Syndicate notified the holders of the certificates of deposit for the General Lien Bonds and the common stockholders of the Old Company of the Reorganization Plan and of their offer to sell to them the new common stock, par value $100, at $40 per share, to be paid in four equal monthly $10 installments on the first days of September, October, November and December, 1909 (R. 7–8, 84–89). By January 1, 1910,

holders of 309,977 of the 313,708 outstanding shares of common stock (par. $50) of the Old Company had deposited their shares under the Plan (R. 8).

On October 9, 1909, upon a report of a special master (Supp. R. 23–24), the Circuit Court entered a Foreclosure Decree, which ordered payment of $10,894,022.23 principal and interest on the General Lien Bonds within five days, and upon default of such payment that all the properties of the Old Company covered by the mortgage be sold, subject to specified superior liens (R. 8, 95–111). The decree then provided for the sale of the property at public auction, and fixed an upset price of $6,500,000 of which at least $250,000 was to be paid in cash (R. 9, 102–103). As part of the purchase price, the purchaser was to assume all secured indebtedness of the Rail Road Company superior to the General Lien Bonds and all unpaid compensation, expenses and obligations of the Receiver (R. 9, 105–107). The decree then provided for the delivery to the purchaser of a deed to the property free from all the liens and claims except as in the decree expressly reserved (R. 9, 109).

Pursuant to the foreclosure decree, on November 19, 1909, the special master sold the mortgaged properties to Henry E. Cooper and Frank C. Nicodemus, Jr., representing the Bondholders' Committee, the only bidders, for $6,500,000 and the court approved the sale (R. 10; Supp. R. 25,

26). On December 1, 1909, Cooper, Nicodemus, and others formed a new corporation under the name The Western Maryland Railroad Company (the taxpayer) with authorized $10,000,000 par value preferred stock ($100 par each) and $50,000,000 par value common stock ($100 par each) to acquire and operate the railroad properties formerly belonging to the Old Company and purchased at the foreclosure sale (R. 10, 111–114). On December 29, 1909, Cooper and Nicodemus assigned to the New Company all of their title and interest as purchasers of the properties at the foreclosure sale, in consideration of $1 and the assumption by the New Company of the purchasers' obligations under the foreclosure decree (R. 10–11, 114–116).

On December 30, 1909, the New Company received a deed to the properties previously covered by the General Lien Mortgage, subject only to the first mortgage and other superior liens and to the condition that it pay or assume the Receiver's obligations (R. 11, 117–125).

As of January 1, 1910, the New Company opened its books and provided for the issuance of the preferred and common stock as provided in the Plan and the various agreements made pursuant thereto (R. 12, 148). On January 21, 1910, the Special Master reported that in payment of the $6,500,000 price accepted on the foreclosure, Cooper and Nicodemus had delivered to him a cer-

tificate of deposit issued by The Equitable Trust Company of New York for $9,930,000 face value in General Lien Bonds, and that the bonds and attached coupons had then been delivered to him and stamped: "Paid on this bond with coupons maturing April 1, 1908, and subsequently, $650, out of the proceeds of the foreclosure sale made November 19, 1909, of the property mortgaged to secure the same" (R. 11; Supp. R. 27–28). He also reported that, of the remaining $70,000 in face value not covered by the certificate of deposit, 19 bonds totaling $19,000 face value were turned in to the depositary and the bondholders paid $650 on each bond; that 51 bonds, totaling $51,000, were still outstanding and that there was due the holders $650 for each, or a total of $33,150, which amount he was depositing with the court. He then turned over to the New Company the sum of $204,168.50, being the balance of the $250,000 cash deposit made by Cooper and Nicodemus, the original purchasers. (R. 11–12; Supp. R. 29–30.)

On May 29, 1911, the taxpayer filed a petition with the court setting forth that the Old Company still had property valued at $151,333.57 not covered by the foreclosed mortgage; that in the foreclosure suit there was $1,810,123.25 in claims of creditors allowed but still unpaid; that there were also unfiled and unpaid claims and judgments against the Old Company totaling $45,604.61; and that there were also claims of bondholders who failed to deposit under the Plan bonds of face value

$70,000 and who had been paid only $650 cash, or a total of $45,500. These constituted all the claims to which the residuary property was subject. The taxpayer then asserted that it had become the owner of these claims,[3] with the exception of the $70,000 of bonds and hence was the substantial equitable owner of the property. (R. 18; Supp. R. 32.) On the same day the court entered an order entitling the holders of the 70 bonds to the option of receiving preferred stock and common stock as set forth in the Reorganization Plan, or in the alternative $20 in cash for each $1,000 bond, and transferring all of the remaining railroad property to the taxpayer (R. 18; Supp. R. 31–34). By December, 1912, holders of 69 of the 70 bonds had surrendered them for preferred and common stock (R. 18, 155, 189).

In the computation of the taxpayer's invested capital the Commissioner of Internal Revenue allowed the following sums as having been paid in upon the issuance as of January 1, 1910, of the preferred and common stock of the Western Maryland Railway Company as a result of the transactions discussed herein (R. 23, 48):

Invested capital paid in for 100,000 shares of $100 par value preferred stock	$7,000,000.00
Invested capital paid in for 239,595.6 shares of $100 par value common stock	12,518,870.10
Total	$19,518,870.10

[3] The District Court stated that the taxpayer "evidently had purchased [the $1,855,727.86 in claims against the Old Company] as cheaply as possible, probably for about $20,000." (R. 18; Supp. R. 45.)

In making the foregoing allowance, the Commissioner determined the fair market value of the preferred stock on January 1, 1910, to be $70 per share, and that of the common stock to be $52.25 per share (R. 23, 48)[4]

The taxpayer claimed invested capital credit for the years 1943, 1944 and 1945 in amounts in excess of the Commissioner's allowance, and paid the resulting excess profits tax deficiencies determined by the Commissioner. It also subsequently claimed that it was entitled to carry back an unused excess profits credit from 1946 to 1944, and to carry over an unused excess profits credit from 1941 to 1943 (R. 45, 46). Upon denial of its claims for refund the taxpayer brought these

[4] The revenue agent's report computed the invested capital, on the basis of these values, as follows (R. 23–24):

Computation of Adjustment to Invested Capital in Connection with the 1909–10 Reorganization

New Preferred & Common Stock is included as follows:	
100,000 shares new 4% Preferred issued for $10,000,000.00 defaulted General Lien & Convertible bonds 100,000 at $70.00	$7,000,000.00
New $100 par Common:	
In exchange for old Common Stock 156,854 at $52.25 per share	8,195,621.50
To General Lien & Convertible Bondholders on payment of $40.00 per share 50,000 at $52.25 per share	2,612,500.00
To General lien (sic) & Convertible Bondholders for overdue interest 8,360 at $52.25 per share	436,810.00
To reorganization Committee for Commissions and expenses 24,381.6 at $52.25	1,273,938.60
Total	$19,518,870.10

actions, which were consolidated for trial (R. 46, 47).

At the trial taxpayer contended, among other things,[5] that, in addition to the $52.25 fair market value per share of common stock of the New Company which the Commissioner allowed, it was also entitled to have allowed as invested capital the $40 cash which was paid for each share. The District Court found that the $52.25 already reflected the money as well as the value of the property paid in and that, since the equity of the stockholders of the Old Company in the railroad property had little or no value after the foreclosure, the Commissioner allowed taxpayer as much or more than it was entitled to when he allowed $52.25 per share as the value of the common stock of the New Company. (R. 38–40.) The District Court accordingly granted judgment for the United States (R. 1–2). The Court of Appeals affirmed in a *per curiam opinion* (Pet. App. 17–19).

ARGUMENT

This case presents a question of fact, namely, the value of stock issued by taxpayer corporation upon its organization, for purposes of determing its equity invested capital. The decision below, affirming the decision of the District Court, is

[5] Other contentions advanced below by the taxpayer (and rejected by both courts below) have been abandoned in the petition.

correct. There is no conflict, and no occasion for further review.

1. Section 718 (a) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 19) defines equity invested capital, for purposes of computing the corporate excess profits tax credit under the World War II Excess Profits Tax Statute,[6] as the sum of money and property paid in for stock. It further provides that property paid in is to be included in equity invested capital in an amount equal to its unadjusted basis for determining loss upon a sale or exchange—in this instance cost.[7] The applicable Treasury Regulations (Section 35.718–1 of Regulations 112 (Appendix, *infra*, p. 20)) provide that where stock issued for property had an established market value, the cost of the property is deemed the fair market value of the stock at the time of its issuance.

In this case, the taxpayer upon its organization in 1910 issued preferred and common stock in exchange for property and money. The property consisted of the mortgaged assets of an insolvent corporation (the Old Company) purchased upon a foreclosure sale by a bondholders committee, which in turn transferred the assets (subject to superior liens) to taxpayer pursuant to a reorgan-

[6] The tax was repealed for taxable years after 1945 by Section 122 of the Revenue Act of 1945, c. 453, 59 Stat. 556.

[7] Section 113 (a) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 19) provides that "The basis of property shall be the cost of such property," with exceptions not here applicable.

ization plan. The money was contributed partly by the bondholders, who received all of taxpayer's preferred stock and purchased some of its common shares, and partly by the common stockholders of the Old Company or their transferees, whose equity interests were wiped out by the foreclosure sale. After a painstaking analysis of the evidence the District Court, sustaining the Commissioner's determination, found that the fair market value of taxpayer's common stock issued upon its organization did not exceed $52.25 per share, and that this price reflected both the money and the property received by taxpayer in exchange for the stock (R. 37–40). These findings are amply supported by the record, and the court below properly refused to disturb them (Pet. App. 17–19).

Discarding other arguments advanced below, taxpayer in its petition now contends that the fair market value of its common stock, which the Commissioner and both courts below found did not exceed $52.25 per share, is attributable in its entirety to the property received by taxpayer, and that an additional $40 per share should be added to that value to represent the money paid by the old common stockholders for shares of taxpayer's common stock. It asserts such claim on the untenable theory that where (as here) stock is issued for a combination of money and property, the statute and the Treasury Regulations require that the entire value of the stock be allocated to the property alone, that the money paid

in then be added to that value, and that the resulting "sum" represents the equity invested capital. In so contending, taxpayer completely ignores the finding below (R. 40) that "the allowance by the Commissioner [$52.25 per share of common] obviously included the $40 per share of cash, and Plaintiff is not entitled to an additional allowance for that amount", as well as the evidence upon which that finding rests.[8]

Indeed, in allowing $52.25 per share as invested capital paid in for the common stock, the Commissioner was exceedingly generous. As the District Court found (R. 38), the Old Company had been hopelessly insolvent in 1908–1909. The foreclosure sale had netted less than two-thirds of the face amount of the $10,000,000 of General Lien Bonds, with nothing left for more than $1,800,000 in claims of general creditors (R. 38–

[8] Contrary to the taxpayer's assumption (Pet. 8–9), the District Court found (R. 38) that the Commissioner did not fail to allow invested capital credit for the $6,274,160 in cash paid in by the common stockholders of the Old Company. As the District Court further found (R. 38), the Commissioner did not fix $8,195,621.50 as the fair market value of the assets of the Old Company. He fixed $52.25 as the fair market value at January 1, 1910, of the common stock of the New Company, $8,195,621.50 as the fair market value of 156,854 shares of such stock, and $12,518,870.10 as the fair market value of the total of 239,595.6 shares of common stock issued at that time. The $52.25 value included the $40 per share cash already paid in as of January 1, 1910, by the depositing stockholders (or their transferees) in the Old Company and by the original holders (or transferees) of warrants issued to the General Lien bondholders.

39) or for holders of common stock. General Lien Bondholders who did not deposit under the Plan received but $650 per bond, i. e., their proportionate share of the foreclosure sale price. (R. 11, 18; Supp. R. 27–30.) Thus the old common stockholders, who were permitted by the bondholders' committee to purchase new common stock at $40 per share, had no remaining equity in the railroad property to pay in to the New Company. Since no provision was made for the payment of the general creditors, it would indeed have been wholly improper for the committee to have preserved any interest of value in the foreclosed property for the common stockholders. *Northern Pacific Ry.* v. *Boyd,* 228 U. S. 482; *Louisville Trust Co.* v. *Louisville &c. R'y,* 174 U. S. 674, 683, 684. The committee likewise gave the bondholders the identical privilege of subscribing to the common stock of the New Company at $40 per share, and taxpayer recognizes that the bondholders paid only cash for the stock (Pet. 7, 8). The District Court properly concluded that the old common stockholders and the bondholders were given the right to subscribe to the new stock at $40 per share, not because they put anything into the New Company in addition to the cash, but merely because they were "the persons most likely to subscribe" (R. 39), a conclusion reinforced by the quotations on the New York Stock Exchange between July, 1909, and January, 1910, for the stock of the Old Company

and for deposit receipts and warrants for purchase of the common stock of the New Company.[9]

Even assuming that the stockholders of the Old Company paid in something in property to the New Company, in addition to the $40 cash per share, taxpayer offered not the slightest evidence which would establish that such property had value in excess of the $12.25 per share allowed by the Commissioner in determining a total value of $52.25 per share. Instead it has relied and continues to rely on nothing more than a

[9] After the reorganization plan was presented by the bondholders' committee on July 6, 1909, the common stock of the Old Company, which sold at a mean of 4 15/16 on that day, steadily declined until at the end of July its average price was only 1 29/32. Through August and September the price ranged between one and six. (R. 39; Supp. R. 10–12.) Those stockholders of the Old Company who desired to avail themselves of the privilege of purchasing the shares of stock of the new were required to surrender their stock certificates and make a down payment of $10 per share of the new stock by September 27, 1909, for which they were to receive transferable purchase warrants. And additional $10 installments were then to be paid in on October, November and December 1, 1909. (R. 91, 92.) When the first published prices for the warrants appeared on the New York Stock Exchange on October 9, 1909, they reflected sales at only $1 in excess of the $20 the holders had up to then been required to put up and did not vary significantly from this price throughout October. (R. 39; Supp. R. 2.) In November, 1909, after payment of the third $10 installment, the warrants sold between $31 and $34. In December, after payment of the full $40, the price went to $43. (R. 39; Supp. R. 3–4.) It is apparent, therefore, as the District Court pointed out (R. 39), that no substantial value was placed upon the right to acquire the new stock.

tenuous interpretation of an isolated segment of a revenue agent's report (R. 25–26; Pet. 8–9). Under well established principles, a taxpayer is not entitled to a tax refund unless he can prove an overpayment, apart from any real or purported error of the Commissioner. *Reinecke* v. *Spalding,* 280 U. S. 227; *Lewis* v. *Reynolds,* 284 U. S. 281; *Stone* v. *White,* 301 U. S. 532, 538; *Helvering* v. *Taylor,* 293 U. S. 507, 514.

2. The lone case upon which taxpayer relies (Pet. 13–15) for conflict (*Brown Shoe Co.* v. *Commissioner,* 339 U. S. 583) presented an issue far removed from that here presented. The question there was whether money and property contributed to a corporation by community groups was includible in its equity invested capital, and the Court held (pp. 592–593) that invested capital may include voluntary contributions by outsiders as well as capital invested by proprietors of the enterprise. No such question is here involved. Both courts below recognized that all of the money and property contributed to taxpayer was includible in its equity invested capital, and they so held. However, they properly disagreed with taxpayer's claim that the fair market value of the common stock issued in exchange, as determined by the Commissioner, reflected only the property but not the money contributed.

The only question presented by this case is one of fact. The Commissioner's determination as to the amount of petitioner's equity invested capital

under Section 718 of the Internal Revenue Code of 1939 has been affirmed by the concurrent findings of the two courts below and is entitled to finality here. *Corn Products Refining Co.* v. *Commissioner,* 350 U. S. 46, 61; *Comstock* v. *Group of Investors,* 335 U. S. 211, 214.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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APRIL, 1956.

APPENDIX

Internal Revenue Code of 1939:

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(26 U. S. C. 1952 ed., Sec. 113.)

SEC. 718 [As added by Sec. 201, Second Revenue Act of 1940, C. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. * * *

* * * * *

(4) *Earnings and profits at beginning of year.*—The accumulated earnings and

profits as of the beginning of such taxable year;

* * * * *

(26 U. S. C. 1952 ed., Sec. 718.)

Treasury Regulations 112, promulgated under the Internal Revenue Code of 1939:

SEC. 35.718–1 *Determination of Daily Equity Invested Capital.—Money and Property Paid in.*—The equity invested capital for any day is determined as of the beginning of such day. The basis or starting point is found in the amount of money and property previously paid in for stock, or as paid-in surplus, or as a contribution to capital. * * *

If the basis to the taxpayer is cost and stock was issued for the property, the cost is the fair market value of such stock at the time of its issuance. If the stock had no established market value at the time of the exchange, the fair market value of the assets of the company at that time should be determined and the liabilities deducted. The resulting net worth will be deemed to represent the total value of the outstanding stock. In determining net worth for the purpose of fixing the fair market value of the stock at the time of the exchange, the property paid in for such stock shall be included in the assets at its fair market value at that time.

* * * * *

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